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CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-90

UNITED STATES OF AMERICA, PETITIONER

v.

CHICAGO, BURLINGTON & QUINCY RAILROAD COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION BELOW

The opinion of the Court of Claims (Pet. 1a–80a) [1] is reported at 455 F. 2d 993.

JURISDICTION

The decision of the Court of Claims was entered on February 18, 1972 (Pet. 1a), but the final judgment has not yet been computed.[2] By order of Chief Justice Burger, the time for filing a petition for a writ of certiorari was extended until July 17, 1972. The petition was filed on July 17, 1972, and certiorari

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[1] "Pet." references are to the petition for a writ of certiorari.

[2] The court held that respondent was entitled to the refund which it sought, but deferred the computation of the amount pending subsequent proceedings pursuant to its rules. (Pet. 80a.)

was granted on October 24, 1972. (App. 113.)[3] The jurisdiction of this Court rests on 28 U.S.C. 1255(1).

QUESTION PRESENTED

Whether, in the computation of its taxable income, respondent railroad was entitled to deduct allowances for depreciation with respect to the costs of certain facilities constructed at highway-railroad intersections, which were paid for not by respondent but out of public funds appropriated for the development of highway systems.

STATUTES INVOLVED

The pertinent provisions of Sections 23, 113 and 114 of the Internal Revenue Code of 1939, and of Sections 167, 1011 and 1012 of the Internal Revenue Code of 1954, are set forth in the Appendix, *infra*, pp. 34–37.

STATEMENT

1. Respondent, an Illinois corporation, is a common carrier by rail in interstate commerce. (Pet. 53a.) Beginning in the early 1930's, various state governments entered into agreements with respondent (as with other railroads) for construction of highway overpasses, underpasses, grade-crossing protection equipment (such as flashing-light signals and automatic gates) and other facilities at highway-railroad intersections. Essentially, respondent agreed to perform that part of the construction work most directly related to railroad use, such as bridges and track

[3] "App." references are to the separately bound record appendix.

signal lights, and the states agreed to perform the work most directly related to highway use, such as roads and approaches for motor vehicles. The agreements also provided that the states would pay from 50 percent to 100 percent of the total cost of the work, including the work performed by respondent. (Pet. 56a.)

After the initial agreements were reached between the states and the railroads, Congress passed a series of acts authorizing the federal government to pay the states' share of the construction costs of facilities at highway-railroad intersections. (Pet. 56a.) Section 204(a) of the National Industrial Recovery Act, 48 Stat. 195, 203 (1933), provided that the government would reimburse the states for—

> all or any part of the cost of * * * the elimination of hazards to highway traffic, such as the separation of grades at crossing, the reconstruction of existing railroad grade crossing structures, the relocation of highways to eliminate railroad crossings, * * * the construction of facilities to improve accessibility and the free flow of traffic, and the cost of any other construction that will provide safer traffic facilities or definitely eliminate existing hazards to pedestrian or vehicular traffic. * * *

In the ensuing years, frequent disputes arose between the governmental bodies and the railroads over the railroads' unwillingness to share in the construction costs of highway-railroad facilities. In order to settle these disputes, Congress passed the Federal-Aid Highway Act of 1944, 58 Stat. 838, Sec. 5 (a) and

(b), which authorized the federal government to reimburse the states for the entire cost of highway-railroad crossing projects (other than rights-of-way), subject only to the limitation that if the railroad received benefits from a constructed facility, it should reimburse the government on a pro rata basis. In no event could the railroad's benefit be deemed more than 10 percent of the cost of the project. (Pet. 47a–48a, 56a–57a.)

Most of the agreements between respondent and the contracting states do not indicate whether respondent or the state has title to the facilities. Under the agreements, however, respondent is required to maintain the facilities "directly related to railroad use," such as bridges, roadbeds and tracks, while the state is required to maintain the facilities "directly related to motor vehicle use," such as highways and approaches. (Pet. 56a.) Although the court below found (Pet. 56a) that respondent was obligated under all of its agreements to replace "at its own expense if needed, equipment originally furnished", the majority of the agreements, as Judge Davis noted in his dissent (Pet. 48a), are silent in this respect. In any event, the majority opinion of the court below did not suggest that the agreements obligate respondents to replace certain types of facilities, such as highway overpasses or underpasses.[4]

[4] Moreover, Section 204(a)(1) of the National Industrial Recovery Act, *supra*, and Sections 1 and 5(a) of the Federal-Aid Highway Act of 1944, *supra*, specifically authorize federal payment for reconstruction of railroad grade crossing structures.

As the Court below found (Pet. 57a), the facilities at issue were constructed "primarily for the benefit of the public, to improve safety and to expedite highway traffic flow."[5] In determining what facilities to build and where to build them, the factors considered by the parties included "the accident statistics of the crossing points and the need for improved motor-vehicle traffic flow." Respondent and the states also considered how many men could be employed on a project, since one goal of the federal government was to create work for persons unemployed during the depression. (Pet. 57a.) The agreements gave no consideration, in allocating funds, to the financial condition or need for capital of respondent and the other railroads. (Pet. 56a.)

The aggregate cost of the publicly funded highway-railroad facilities with respect to which respondent now seeks to take depreciation was $2,146,140, of which $1,538,543, or 71 percent, represented highway undercrossings or overcrossings; $548,877, or 26 percent, crossing signals, signs and floodlights; and $58,721 jetties and bridges. (Pet. 55a.)

2. On February 5, 1943, respondent requested permission of the Internal Revenue Service to change from retirement to depreciation accounting for road property. (Pet. 57a.) On April 12, 1943, the Service responded by letter (App. 56), enclosing Mimeo 58, entitled "Change from Retirement to Depreciation

[5] Respondent did, however, receive some benefit from the facilities, including probable lower accident rates, reduced expenses of operating crossing facilities, and, where permitted, higher train speed limits. (Pet. 57a.)

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Accounting for Road Property" (App. 57–66). Mimeo 58 was prepared by the Service for circulation to the railroads generally, many of whom were seeking to change from retirement to depreciation accounting during World War II. Setting out guidelines under which the changeover would be acceptable to the Service (Pet. 58a), Mimeo 58 provided in part that (Pet. 8a–9a):

> The basis for depreciation shall be *the cost of the existing depreciable property to the present taxpayer,* determined in accordance with sections 113 and 114(a) of the Internal Revenue Code. * * *
>
> * * * * *
>
> The basis may include only the investment in property which is actually depreciable. * * * *Donated property or contributions or grants in aid of construction from any source must be excluded.* [Emphasis added.]

Mimeo 58 also required that a railroad seeking to make the change in accounting methods furnish the Service with a list of the properties with respect to which it intended to take depreciation, together with their cost basis, salvage value, expired life, and estimated normal useful life. When respondent thereafter furnished the information required by Mimeo 58, it did not include the highway-railroad facilities paid for out of public funds. (Pet. 58a.)

On September 20, 1944, the Service sent respondent a terms letter (App. 52–54), which incorporated the information supplied by respondent with respect to

the property it intended to depreciate and which referred to some of the requirements set out in Mimeo 58. The letter, which did not refer expressly to the treatment of donated property, granted respondent permission "to change from retirement to depreciation accounting as of January 1, 1943," to be effective "upon receipt of a letter agreeing to all the terms and conditions set forth herein." On April 20, 1945 (App. 55), respondent accepted the terms letter with the proviso that its acceptance should not bar it from the benefit of any change in the conditions of the terms letter brought about "by statutory amendment, by operation of law, or otherwise" (Pet. 58a).

On May 1, 1961, respondent requested that the Service permit it to take advantage of the benefit of Section 94 of the Technical Amendments Act of 1958 (known as the Retirement-Straight Line Adjustment Act of 1958), P.L. No. 85–866, 72 Stat. 1669. (See, *infra*, p. 29, n. 14.) Respondent attached to this request revised schedules of its depreciable roadway properties, which again omitted the highway-railroad facilities paid for out of public funds. Responding to this request by letter of July 26, 1961 (App. 68–70), the Service referred to the earlier terms letter and stated that respondent's revised schedules were acceptable effective January 1, 1956, provided respondent had made a timely election as required by Section 94. Respondent had made the necessary election on December 14, 1959. (Pet. 58a–59a.)

3. Respondent brought suit in the Court of Claims alleging that it overpaid its 1955 income tax when

it failed to take deductions for depreciation with respect to the cost of the facilities paid for out of public funds. The Court of Claims held, with three judges dissenting, that respondent was entitled to include in its depreciation base the entire $2,146,140 paid for or reimbursed out of public funds and to take deductions therefor. The majority, relying on *Brown Shoe Co.* v. *Commissioner,* 339 U.S. 583, reasoned that even though the governmental payments were not intended to be contributions to respondent's capital but, rather, were intended to absorb part of the cost of building public highway systems, the facilities involved did, in fact, enlarge respondent's working capital and produce economic benefits for respondent; therefore the facilities were depreciable under Section 113(a)(8)(B) of the Internal Revenue Code of 1939, Appendix, *infra,* pp. 34–35, which prescribed a carryover of the transferor's basis for property acquired by a corporation as a contribution to its capital.

Judge Davis, writing for the three dissenting judges, noted that under the test set forth in *Brown Shoe,* and in *Detroit Edison Co.* v. *Commissioner,* 319 U.S. 98, there is no contribution to a corporation's capital and, correspondingly, no depreciable basis under Section 113(a)(8)(B), unless property is transferred with a purpose or intent to enlarge the transferee's capital. Here, the dissent reasoned, the states and the federal government paid for the facilities involved not in order to confer a benefit on respondent, but solely in order to expedite the flow of traffic and improve

public safety at highway-railroad crossings. (Pet. 46a-49a.)

The dissent also took the view that respondent had agreed in the 1944 terms letter to exclude the donated property from its depreciation base as one of the conditions to the Service's consent to respondent's change from retirement to depreciation accounting, and that this agreement was binding. (Pet. 49a.) The majority held that respondent had not made a binding agreement to exclude the donated property from its depreciation base. (Pet. 8a-10a.)

SUMMARY OF ARGUMENT

I. Respondent is not entitled under the 1939 Code to depreciation deductions with respect to the facilities at issue here.

A. Under both the 1939 and 1954 Internal Revenue Codes, taxpayers are allowed to take a reasonable depreciation deduction designed to reflect that portion of the taxpayer's investment in certain capital assets which is used up each year through wear and tear and obsolescence. To that end, the basis on which depreciation is allowed with respect to property under both the 1939 and 1954 Codes is generally the cost of that property to the taxpayer. If a taxpayer has made no investment in an asset, so that its gradual consumption represents no actual expense to him, the reason for allowing depreciation does not apply. See *Massey Motors, Inc.* v. *United States,* 364 U.S. 92, 96.

The Internal Revenue Code of 1939, however, which governs the issue before the Court in this case, pro-

vided a limited exception to the general rule that a taxpayer can only depreciate its cost basis in an asset. Section 113(a)(8)(B) of that Code, Appendix, *infra*, pp. 34–35, allowed corporate taxpayers to take depreciation on property acquired after 1920, either from shareholders or nonshareholders, as a "contribution to capital." This provision produced an anomalous result, in that it allowed taxpayers to take depreciation deductions with respect to assets in which they not only had no investment, but which, under this Court's decision in *Edwards* v. *Cuba Railroad*, 268 U.S. 628, they had received free of income tax liability.

Congress recognized the inconsistency inherent in the allowance of depreciation in these circumstances when it enacted Section 362(c) of the Internal Revenue Code of 1954, which provides that assets donated by nonshareholders as contributions to capital have a zero basis in the hands of the transferee. Nonetheless, in cases such as this one which are governed by the 1939 Code, it is necessary to determine whether the donated assets are contributions to the taxpayer's capital, in which case they are depreciable. In retrospect it seems clear that the inquiry whether the transfers were technically contributions to capital ought not to have determined the depreciability of the assets. Though respondent, of course, would be entitled to a depreciation deduction if it were afforded to it by the terms of the 1939 Code, it is reasonable to conclude, in view of the inconsistency between the allowance of depreciation for assets donated by nonshareholders

and the fundamental concept of depreciation as a means of recovering costs actually incurred, that Congress intended that this exceptional provision of the 1939 Code would apply only in a narrow range of circumstances. Indeed, the decisions of this Court establish a rigorous standard which taxpayers must meet in order to depreciate donated assets, a standard not met by the donated properties at issue here.

B. This Court has twice considered whether assets transferred to a corporation by nonshareholders represented "contributions to capital" as that term is used in Section 113(a)(8)(B) of the 1939 Code. In *Detroit Edison Co.* v. *Commissioner,* 319 U.S. 98, the Court denied a depreciation allowance to a taxpayer utility company which sought to depreciate electric power lines which its customers had been required to pay for in order to receive the company's services. In *Brown Shoe Co.* v. *Commissioner,* 339 U.S. 583, the Court allowed taxpayer to depreciate factory buildings and equipment donated by community citizen groups in order to induce taxpayer to locate or expand its operations in that community. In both these cases the Court tested the assets in question in terms of whether the transferor had a donative intent to increase, or "contribute" to, the capital of the transferee corporation.

In this case, the governmental agencies which contributed the highway-railroad facilities at issue clearly did not intend to "enlarge the working capital" (*Brown Shoe,* 339 U.S. at 591) of the respondent railroad. As the Court of Claims found, "The facili-

ties * * * were constructed primarily for the benefit of the public to improve safety and to expedite highway traffic flow" (Pet. 57a), and no consideration was given to respondent's need for capital (Pet. 56a). Nor, as Judge Davis noted in his dissent (Pet. 47a), were the facilities of more than marginal benefit or relevance to respondent's railroad business.

The argument of the majority below that respondent is entitled to depreciate these facilities because it is obligated to maintain and replace them at its own expense is not supported by the record. In any event, even if respondent were obligated to maintain and replace these facilities, this would not in itself entitle respondent to take depreciation with respect to these assets. Depreciation is a deduction taken for the exhaustion of an existing investment; there is no depreciation allowance for a future investment. *Weiss* v. *Wiener,* 279 U.S. 333. Of course, if respondent incurs maintenance and repair costs with respect to these facilities in the future, it can deduct these expenses as they occur. If respondent replaces facilities as they become worn out, it can include the assets which it pays for in its depreciable base at that time.

II. Even if, contrary to our contention, respondent's claim is consistent with the standard set forth by this Court in *Detroit Edison* and *Brown Shoe,* the terms letter which respondent entered into in order to change its accounting method from retirement to straight-line barred respondent from taking depreciation on the donated highway-railroad facilities. In the terms letter, respondent "irrevocably" agreed to ex-

clude "[d]onated property or contributions or grants in aid of construction from any source." (Pet. 58a.) The courts which have considered the effects of these terms letters have generally held or assumed that they are binding.

In support of its conclusion that respondent was not obligated by the terms letter to exclude donated property from its depreciable base, the majority below placed considerable emphasis (Pet. 10a) on the fact that respondent had accepted the terms letter with the provision that its acceptance would not bar respondent from taking advantage of the benefit of any change in the conditions of the terms letter brought about "by statutory amendment, by operation of law, or otherwise." In the majority's view, this Court's decision in *Brown Shoe* brought about a change in the conditions of the terms letter because under that decision respondent would be allowed to take depreciation with respect to the donated assets at issue in this case. *Brown Shoe,* however, does not embody the kind of change in the law that would release respondent from the obligations agreed to in the terms letter, for *Brown Shoe* did not change or purport to change the applicable standard of depreciability which the Court had earlier used in *Detroit Edison.* Respondent itself appears to have recognized this. Indeed, for more than ten years after *Brown Shoe* was decided, respondent continued to exclude donated property from its depreciable accounts. Furthermore, in May 1961, respondent "irrevocably" accepted the conditions of the terms letter a second time, eleven years after the de-

cision in ***Brown Shoe,*** when it agreed not to include donated assets in its depreciable base as a condition to obtaining the benefits of the Retirement-Straight Line Adjustment Act of 1958, 72 Stat. 1669.

ARGUMENT

I. RESPONDENT IS NOT ENTITLED TO DEPRECIATION DEDUCTIONS WITH RESPECT TO THE FACILITIES AT ISSUE HERE, BECAUSE THE GOVERNMENTAL AGENCIES WHICH PAID FOR THESE FACILITIES DID NOT HAVE THE REQUISITE INTENT TO ENLARGE RESPONDENT'S CAPITAL; CONSEQUENTLY, THE FACILITIES ARE NOT DEPRECIABLE CONTRIBUTIONS TO CAPITAL UNDER THE INTERNAL REVENUE CODE OF 1939

A. THE PROVISION OF THE INTERNAL REVENUE CODE OF 1939 WHICH ALLOWED CORPORATIONS TO DEPRECIATE ASSETS DONATED TO THEM AS CONTRIBUTIONS TO CAPITAL SHOULD BE NARROWLY CONSTRUED

Section 23(l) of the Internal Revenue Code of 1939, Appendix, *infra,* p. 34, and its successor, Section 167(a) of the 1954 Code, Appendix, *infra* p. 36, authorize taxpayers to take a reasonable depreciation deduction for the exhaustion, wear and tear, and obsolescence of property used in a taxpayer's trade or business. The purpose of the depreciation allowance is to allow a taxpayer to deduct from his taxable income the portion of his investment in certain capital assets which may have been used up in earning that income. *United States* v. *Ludey,* 274 U.S. 295, 300–301; *Helvering* v. *Lazarus & Co.,* 308 U.S. 252; *Massey Motors, Inc.* v. *United States,* 364 U.S. 92; *Fribourg Nav. Co.* v. *Commissioner,* 383 U.S. 272. To that end, the basis on which depreciation is allowed with respect to property under both the 1939 and 1954 Codes is

generally the cost of that property to the taxpayer, adjusted to reflect prior depreciation. Section 113(a) and (b)(1)(B) and Section 114(a) of the 1939 Code, Appendix, *infra,* pp. 34–36; Sections 167(f), 1011 and 1012 of the 1954 Code, Appendix, *infra,* pp. 36–37. By defining a taxpayer's depreciable basis in terms of cost, Congress manifested its intention that the depreciation deduction should reflect approximately the portion of a taxpayer's expense incurred in the purchase of an asset which is attributable to the production of income in any particular year. As described by a House Report on the 1954 Code, quoted by this Court in *Massey Motors, supra,* 364 U.S. at 102–103:

> "Depreciation allowances are the method by which the capital invested in an asset is recovered taxfree over the years it is used in a business. The annual deduction is computed by spreading the cost of the property over its estimated useful life." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 22.[6]

It follows that, if a taxpayer has made no investment in an asset, so that its gradual consumption represents no actual expense to him, the reason for allowing depreciation does not apply, any more than the rationale for a business expense would apply to a taxpayer who has incurred no expenses. As this Court said in *Massey Motors,* 364 U.S. at 101, "Congress intended by the depreciation allowance not to make

[6] It may be said that "the depreciation allowance is nothing more than the deduction of an estimated *expense incurred by a taxpayer* and reflects the consumption of the capital assets earning the income." *United States* v. *Milnor Corp.,* 85 F. Supp. 931, 938 (E.D. Pa.).

taxpayers a profit thereby, but merely to protect them from a loss."

The Internal Revenue Code of 1939, however, which governs the issue before the Court in this case (see *infra,* p. 17), provided a limited exception to the general rule that a taxpayer can only depreciate its cost basis in an asset. Section 113(a)(8)(B) of that Code, Appendix, *infra,* pp. 34-35, allowed corporate taxpayers to take depreciation on property acquired after 1920, either from shareholders or nonshareholders, as a "contribution to capital." The depreciable basis of property acquired in this manner is the basis of the property in the hands of the transferor, which, in the case of the new assets at issue here, is the transferor's cost. Sections 113(a)(8)(B) and 114(a).

The 1939 Code's allowance of depreciation with respect to assets transferred as contributions to capital, for which the transferee corporation has incurred no cost or expense, produced an anomolous result, especially when it was placed along side this Court's holding in *Edwards* v. *Cuba Railroad,* 268 U.S. 628. In *Cuba Railroad,* the Court held that subsidies given by the Cuban government to promote the construction of railroads in Cuba "were not profits or gains from the use or operation of the railroad," and, consequently, did not constitute income to the transferee corporation. 268 U.S. at 633. The net effect of Section 113 (a)(8)(B) of the 1939 Code and the holding in *Cuba Railroad* was that corporate taxpayers who received donated assets which could be categorized as "contributions to capital" were able to take depreciation

deductions with respect to assets in which they not only had no investment, but which they had also received free of income tax liability.

Congress recognized the inconsistency inherent in the allowance of depreciation in these circumstances when it enacted the Internal Revenue Code of 1954. Section 362(c) of the 1954 Code provides that contributions to capital made by nonshareholders after June 22, 1954, have a basis of zero in the hands of the transferee; consequently, no depreciation deduction can be taken with respect to these assets.[7] The instant case, of course, which involves assets donated prior to June 22, 1954, is governed by the 1939 Code, which allowed depreciation of assets transferred by nonshareholders if the transfers could be classified as contributions to capital. See Sections 362(a) and 1052 (c) of the 1954 Code. Thus, in order to determine whether donated assets are depreciable under the 1939 Code, the courts are required to determine whether the transfers in qustion are, in fact, "contributions to capital" as that term was used in Section 113(a)(8) (B). See *infra*, pp. 18–26.

In retrospect, it seems clear, as Congress recognized when it enacted Section 362 of the 1954 Code, that the inquiry whether assets donated by nonshareholders represented contributions to capital ought not to have been determinative of the question whether the assets were depreciable. This does not, of course, mean that respondent would not be entitled to the depreciation deduction if it were afforded to it by the terms

[7] Under Section 118(a) of the 1954 Code, contributions to capital are excluded from the gross income of the recipient.

of the 1939 Code, which clearly governs the depreciability of the properties under consideration in this case. But, in view of the conspicuous inconsistency between the allowance of depreciation for assets donated by nonshareholders and the fundamental concept of depreciation as a means of recovering costs actually incurred in a taxpayer's trade or business, reflected in both the 1939 and 1954 Codes, we suggest that it is reasonable to conclude that Congress intended that this exceptional provision of the 1939 Code would apply only in a narrow range of circumstances. Correspondingly, the decisions of this Court which have interpreted the term "contribution to capital" in the context of Section 113(a)(8)(B) of the 1939 Code have established a rigorous standard which taxpayers must meet in order to depreciate donated assets. In our view, the donated properties at issue in this case do not meet that standard.

B. THE HIGHWAY-RAILROAD FACILITIES DONATED TO RESPONDENT BY THE GOVERNMENTAL AGENCIES ARE NOT DEPRECIABLE CONTRIBUTIONS TO CAPITAL BECAUSE, UNDER THE STANDARDS ESTABLISHED BY THIS COURT, THEY WERE NOT DONATED WITH THE INTENTION OF ENLARGING RESPONDENT'S CAPITAL

This Court has twice considered whether assets transferred to a corporation by nonshareholders represented "contributions to capital" as that term is used in Section 113(a)(8)(B) of the 1939 Code. In both cases, the Court tested the assets on which taxpayers claimed depreciation in terms of whether the transferor had a donative intent to increase, or "contribute" to, the capital of the transferee corporation. In *Detroit Edison Co.* v. *Commissioner,* 319 U.S. 98,

the taxpayer utility company sought to depreciate electric power lines which its customers had been required to pay for in order to receive the company's services. The Court rejected the contention that taxpayer's customers had contributed these assets to taxpayer's capital. "It * * * overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company * * *. * * * The payments were to the customer the price of the service." 319 U.S. at 102–103. The Court noted that ordinarily a taxpayer's depreciable basis is determined with reference to the cost it has incurred in obtaining its depreciable assets, and that here taxpayer had not even been required, because of the holding in *Cuba Railroad, supra,* to treat the receipt of the power lines as income. The opinion concluded that the taxpayer should not be permitted to "recoup through untaxed depreciation accruals on investments it has refused to make." 319 U.S. at 103.

Detroit Edison has been followed in *Commissioner* v. *Arundel-Brooks Concrete Corp.,* 152 F. 2d 225 (C.A. 4); *Denver & Rio Grande Western Railroad Co.* v. *Commissioner,* 32 T.C. 43, 45–46, affirmed on other grounds, 279 F. 2d 368 (C.A. 10); and *John B. White, Inc.* v. *Commissioner,* 55 T.C. 729, affirmed *per curiam,* 458 F. 2d 989 (C.A. 3), certiorari denied, October 10, 1972. In each of these cases, nonshareholders gratuitously transferred property to the taxpayers which added some incremental value to the taxpayer's working capital, but which was primarily intended to yield direct benefits to the transferors.

In 1950, seven years after the *Detroit Edison* decision, the Court decided *Brown Shoe Co.* v. *Commissioner*, 339 U.S. 583. In that case, community citizen groups, in order to induce taxpayer to locate or expand its operations in that community, donated to taxpayer factory buildings and equipment and cash to be used in the construction of manufacturing facilities. The only restriction imposed on the use of these donated assets was that they were to be used in the taxpayer's business at agreed locations for specified minimum periods of time. Emphasizing that the intent of the community groups was to add assets to taxpayer's working capital without imposing requirements or restrictions, the court held that the assets represented contributions to taxpayer's capital. Distinguishing the case from *Detroit Edison,* where the transfers were made with a "different purpose" (339 U.S. at 591), the Court said (*ibid*):

> The contributions to petitioner were provided by citizens of the respective communities who neither sought nor could have anticipated any direct service or recompense whatever, their only expectation being that such contributions might prove advantageous to the community at large. Under these circumstances the transfers *manifested a definite purpose to enlarge the working capital of the company.* [Emphasis added.] [8]

[8] In neither *Detroit Edison* nor *Brown Shoe* was there any dispute that the property was exhaustible or that it was used for the economic benefit of the transferee in its business. Nor was there any inference that the taxpayer did not have the burden of maintaining and replacing the property in the future

In this case, the governmental agencies which contributed the highway-railroad facilities at issue clearly did not intend to "enlarge the working capital" of the respondent railroad. Indeed, the Court of Claims specifically found that "The facilities * * * were constructed primarily for the benefit of the public to improve safety and to expedite highway traffic flow" (Pet. 57a), and that the transferors gave no consideration to respondent's need for capital (Pet. 56a). In holding, despite these findings, that the state and federal governments contributed the facilities at issue here to respondent's capital, the court has rejected the test for a contribution to capital set forth by this Court in *Detroit Edison* and *Brown Shoe.*

Nor did the outlay of public funds for the assets respondent seeks to depreciate here actually result in any significant enlargement of respondent's working capital, as did the expenditures at issue in *Brown Shoe.* The facilities, designed to improve safety and highway traffic flow, were obviously peripheral to respondent's business of operating a common carrier by rail. Indeed, the highway overpasses and underpasses, which constitute 71 percent of the total ex-

(see *infra*, pp. 23–25). The only distinction between the cases was in the purpose of the transferors.

In a recent case decided under the 1954 Code, *Federated Dept. Stores* v. *Commissioner*, 426 F.2d 417 (C.A. 6), a real estate developer made donations to the taxpayer to induce it to locate a store in a shopping center on the developer's land. The court held that the donations were excludable from the taxpayer's income, as contributions to capital under Section 118, because any future benefits to the developer, as distinguished from the community, were speculative and indirect. This decision and its rationale are compatible with *Brown Shoe.*

penditures involved here (Pet. 55a), are used in a manner that is essentially unrelated to respondent's business.[9] To the extent that the facilities were deemed to have benefited respondent, Section 5 of the Federal-Aid Highway Act of 1944, 58 Stat. 838, contemplated that respondent would pay its share of the costs. As both *Detroit Edison* and *Brown Shoe* imply, a benefit of this sort, not fundamentally designed to enhance the railroad's assets, does not turn a public expenditure into a contribution to respondent's corporate capital.

Judge Davis, speaking for the three dissenting judges below, reasoned (Pet. 47a)—

> Congress, which funded all or the lion's share of the "donations" as part of the federal highway program, did not have in mind awarding any substantial gratuities to the railroads or increasing their capital. The intended beneficiaries of the program, ultimate and immediate, were the people at large, the auto-travelling segment of the public, and the trucking industry. * * * The benefits to the railroads were small, indirect, and merely incidental—not, as in *Brown Shoe,* large, direct, intended, and immediate. The highway program was certainly not undertaken in order to give free aid to the railroads. What they may have gained was no more than a minor by-product of the overriding aim of Congress (and the states) to reach very different goals. The physical assets left with the

[9] Indeed, it may well be that in expediting the flow of automobile, bus and truck traffic, these facilities stimulated respondent's competition and in this respect were contrary to respondent's interests.

> railroads were not central to their business, as in *Brown Shoe* and *Commissioner* v. *McKay Products Corp.,* 178 F. 2d 639, 643 (C.A. 3, 1949), but were peripheral and tangential. That the railroads were to receive these items was not the prime and significant purpose of the Federal Government or the states, but a casual consequence, as it were, of the highway program which had other ends.[10]

In support of its holding that respondent was entitled to depreciate the facilities in question, the majority of the Court of Claims attached "principal importance" to its conclusion that respondent was obligated under its contracts with the states to maintain the facilities and replace them at its own expense. (Pet. 7a–8a.) The record, however, does not support this conclusion. The agreements between respondent and the states obligated respondent to maintain only the facilities directly related to railroad use, such as bridges, roadbeds and tracks; the states were required to maintain the highway portion of the facilities. (Pet. 56a.) Some of the agreements obligated respondent to

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[10] That the governmental bodies lacked a donative intent in the construction of these facilities is confirmed by this Court's opinion in *Nashville, C. & St. L. Ry.* v. *Walters*, 294 U.S. 405, 421–424, 427. The issue in that case was whether it was reasonable for a state to impose upon the Railway company 50 percent of the cost of highway overpasses and underpasses at rail crossings constructed as part of the Federal-Aid highway program. The Court held that the Supreme Court of Tennessee erred in failing to give weight to the Railway's evidence that the requirement was unreasonable on the ground that the program was for the benefit of the public at large and particularly drivers of motor vehicles, not for the Railway.

replace "equipment originally furnished", but most of the agreements were silent in this respect. (Pet. 48a, 56a.) The majority below did not suggest that respondent was obligated to replace highway overpasses or underpasses. Even if there were such an obligation, it would have little meaning, for Sections 1 and 5(a) of the Federal-Aid Highway Act of 1944, *supra,* specifically authorized reconstruction of railroad grade crossing structures at federal expense.

But even if respondent were obligated to maintain and replace the facilities at issue in the broad manner suggested by the majority below, this would not in itself entitle respondent to take depreciation with respect to these assets. Depreciation is an allowance for the exhaustion of an existing investment; there is no depreciation allowance for a future investment. As this Court said in *Weiss* v. *Wiener,* 279 U.S. 333, 335-336, where a claimed depreciation deduction was not allowed:

> * * * the loss must be actual and present, not merely contemplated as more or less sure to occur in the future. * * *
>
> * * * it is not enough that [taxpayer] has made a contract that very possibly may not be carried out to replace that capital at some future time.[11]

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[11] See also *Reisinger* v. *Commissioner,* 144 F.2d 475, 478 (C.A. 2), where the court said:

> Only a taxpayer who has a depreciable interest in property may take the deduction, and that interest must be in existence in the taxable period to enable him to show a then actual diminution in its value. It is not enough that the taxpayer may in the future have to make an investment which will then depreciate in value.

Of course, if respondent incurs maintenance and repair costs with respect to these facilities in the future, it can deduct these expenses as they occur. If respondent replaces facilities as they become worn out, it can include the assets which it pays for in its depreciable base at that time.[12]

Respondent seeks here to take a depreciation deduction with respect to assets in which it has no investment and which it has received free of income tax liability as well as free of cost. To permit the depreciation deduction which respondent seeks would impute to Congress the intent to pay twice for the railroad-highway crossing projects constructed at the site of respondent's railroad—once as a part of the Federal-Aid highway program, and once again, to the extent of approximately 50 percent of the cost of the projects, through deductions from respondent's taxable income. To expand in this manner Section 113's

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[12] The majority of the court below cites (Pet. 8a) *Helvering* v. *Lazarus & Co.*, 308 U.S. 252, for the proposition that "depreciation deductions go to the party which 'bears the burden of wear and exhaustion of business property,' irrespective of who may have legal title." The taxpayer in *Lazarus & Co.*, however, had a capital investment in the assets it sought to depreciate and was allowed depreciation precisely for that reason. The taxpayer had transferred the assets to a bank in trust, and then leased them back with an option to purchase. This Court held that (p. 255) "the transaction between the taxpayer and the trustee bank, in written form a transfer of ownership with a lease back, was actually a loan secured by the property involved." The Court held that the taxpayer, though technically a lessee, was using (p. 254) "business property in which it had a depreciable capital investment," and was accordingly entitled to depreciation allowances with respect to that property.

narrow exception to the rule limiting depreciation to taxpayer's cost basis is inconsistent with the entire rationale of the depreciation deduction and is in conflict with the decisions of this Court.

II. THE TERMS LETTER WHICH RESPONDENT ENTERED INTO IN ORDER TO CHANGE ITS ACCOUNTING METHOD BARRED RESPONDENT FROM TAKING DEPRECIATION ON THE DONATED HIGHWAY-RAILROAD FACILITIES

Prior to World War II, respondent and other railroads used the retirement method of computing depreciation on their roadway and various other properties. Under this method, the deduction allowed for depreciation is measured by the cost of the assets retired from service during the year. The war years brought about high income and low retirements and, as a consequence, railroads using the retirement method sought to change to the straight-line depreciation method.[13]

For many years, the consent of the Commissioner has been a prerequisite to any change in the method of accounting which a taxpayer employs in computing his income. Treasury Regulations 111 (1939 Code), Section 29.41-2; Treasury Regulations 118 (1939 Code), Section 39.41-2(c); Section 446(e) of the 1954 Code. The Commissioner was generally willing to con-

[13] "[U]nder the retirement method, the original cost of an asset (less salvage value) is charged off against income at the time of the retirement of the asset from use. * * * Under the straight-line method * * *, the original cost of an asset (less salvage value) is charged against income by means of annual deductions over its useful life." S. Rep. No. 1983, 85th Cong., 2d Sess., pp. 107-108.

sent to the railroads' change to straight line depreciation provided that the railroads entered into agreements, called "terms letters", embodying certain specific restrictions on their depreciation deductions. See *Chicago, Milwaukee, St. Paul & Pacific R. Co.* v. *United States,* 404 F. 2d 960, 969–970 (Ct. Cl.).

On April 12, 1943, the Service wrote in reply to respondent's request for consent to change its depreciation method. (App. 56.) The Service announced in this letter that it was enclosing "a mimeograph which states the terms under which permission will be granted and describes the information that should be furnished." The mimeograph enclosed was Mimeo. 58 (App. 57–66), which had been prepared for general circulation to the railroads (Pet. 58a). Miméo. 58 required that an applicant railroad "irrevocably" agree to include in its basis for depreciation (App. 59) "only the investment in property which is actually depreciable,'" and to exclude "[d]onated property or contributions or grants in aid of construction from any source." Respondent was requested to furnish schedules of property which it proposed to depreciate under the straight-line method.

As stated above (*supra,* p. 6), respondent furnished the information required by Mimeo 58, including proposed schedules of depreciable property, which did not include the highway-railroad facilities paid for out of public funds. (Pet. 58a.) The Service subsequently sent respondent a terms letter dated September 20, 1944 (App. 52–54), which granted the permission respondent sought on the condition that re-

spondent "irrevocably" agree to all the terms and conditions in the letter. The terms letter incorporated with approval the schedules respondent had furnished of the properties it proposed to depreciate, with the proviso (App. 52) that any remaining recovery through depreciation allowances "shall be limited to the cost or other basis less the depreciation so accrued." The terms letter did not expressly reiterate the requirement of Mimeo 58 that donated property should be excluded from respondent's depreciable accounts. As noted, however, respondent had already complied with that requirement by excluding donated property from its proposed schedules of depreciable assets.

Thus respondent irrevocably agreed, as a condition to the Commissioner's consent to changing its accounting method, that donated property would be excluded from its depreciable accounts. The fact that the terms letter did not reiterate the exclusion of donated property required by Mimeo 58—an exclusion reflected in the depreciation accounts submitted by respondent and incorporated in the terms letter—does not remove that exclusion from the scope of the agreement between respondent and the Commissioner. As Judge Davis noted (Pet. 49a):

> Mimeo 58, which explicitly excludes donated property from straight-line depreciation, is entwined with the terms letter and forms an integral part of the mutual understanding for the change-over from retirement accounting.

The courts have generally held or assumed that the terms letters between the Commissioner and the rail-

roads are binding. The Court of Claims, for example, has rejected a contention that the depreciation rates required by the terms letters represented an abuse of the Commissioner's discretion. *Chicago, Milwaukee, St. Paul & Pacific R. Co.* v. *United States, supra.* And in determining the applicability of terms letters to losses on abnormal retirements, the Tax Court has assumed that these agreements were fully binding on the railroads. *Denver & Salt Lake Railway Co.* v. *Commissioner,* 24 T.C. 709; *Denver & Rio Grande Western Railroad Co.* v. *Commissioner,* 32 T.C. 43, affirmed on other grounds, 279 F. 2d 368 (C.A. 10).[14]

In support of its conclusion that respondent was not obligated by the terms letter to exclude donated property from its depreciable base, the majority below placed considerable emphasis (Pet. 10a) on the fact that respondent, in its letter to the Service of April 20, 1945 (App. 55), accepted the terms letter with the proviso that its acceptance would not bar respondent from taking advantage of the benefit of any change in the conditions of the terms letter brought about "by statutory amendment, by operation of law, or other-

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[14] During the 1950's, a controversy arose between the railroad industry and the Commissioner as to the validity of a requirement in the terms letters that taxpayers set up a 30 percent depreciation reserve. This controversy was resolved by enactment of Section 94 of the Technical Amendments Act of 1958 (known as the Retirement-Straight Line Adjustment Act of 1958), P.L. No. 85-866, 72 Stat. 1669, which modified the 30 percent reserve requirement for railroads electing the benefits of that Act. But that legislation was premised on the binding force of the terms letters, and was enacted by Congress to release the railroads from their agreement, but only to the extent specified in the statute.

wise." In the majority's view, this Court's decision in *Brown Shoe* brought about a change in the conditions of the terms letter because under that decision respondent would be allowed to take depreciation with respect to the donated assets at issue in this case.[15]

Even if, contrary to our contention, the standard applied in *Brown Shoe* does not preclude respondent from depreciating the donated properties at issue here, we submit that the *Brown Shoe* decision does not embody the type of change in the law that would release respondent from the obligations agreed to in the terms letter. To begin with, *Brown Shoe* did not change or purport to change the applicable standard of depreciability which the Court had earlier used in the *Detroit Edison* case. Though these two cases reached different results on substantially different facts, both held that the donative intent of the transferor determines whether assets such as those at issue here represent contributions to capital under Section 113(a)(8)(B). See *supra*, pp. 18–26. Indeed, respondent itself appears to have recognized that *Brown Shoe* did not change the standard of depreciability of

[15] If this Court agrees with our interpretation of *Brown Shoe*, of course, it need not consider the effect of the terms letter, for the majority's holding that *Brown Shoe* changed the conditions of the terms letter is premised upon its view that respondent is entitled under the holding in *Brown Shoe* to depreciate these donated properties. If the Court does not agree with our view that respondent is precluded from taking depreciation with respect to these properties by the standard set forth in *Brown Shoe* and *Detroit Edison*, then our position is that the terms letter barred respondent from including the donated properties in its depreciable base.

donated assets; significantly, for more than ten years after *Brown Shoe* was decided, respondent continued to exclude donated property from its depreciable accounts (see, *infra*, p. 32).

Respondent's reservation of the right to benefit from any changes brought about "by statutory amendment, by operation of law, or otherwise," surely could not operate to free respondent of conditions in the terms letter by reason of judicial decisions which did not constitute a clear departure from prior law, but which merely reflected an evolving interpretation of existing law, as in the case of *Brown Shoe.* If the covenants exacted by the Commissioner as a condition to his allowing taxpayers to change their accounting methods are to have any significance, their bar cannot be limited to claims that are obviously frivolous under the statutory and decisional law; they must also mean at least that taxpayers have agreed not to assert claims that might, if litigated, be held consistent with the rationale of some future judicial decision. Otherwise, respondent's agreement not to include these donated properties in its depreciable base would be meaningless, for it would mean that respondent agreed only to refrain from doing what it would have no arguable legal basis to do.

Furthermore, in May 1961, when respondent requested permission to take advantage of the Retirement Straight Line Adjustment Act of 1958, 72 Stat. 1669, it submitted revised schedules of its depreciable roadway properties which did not include the donated highway

railway facilities. The Service replied to respondent's request by letter of July 26, 1961. (App. 68.) In accordance with Section 94(e) of that Act, which provided that the conditions contained in the terms letters signed in the 1940's would be binding on the railroads electing the benefits of the Act, the Service's letter referred to the original terms letter and stated that respondent's revised depreciation schedules would become effective January 1, 1956, provided that respondent had made a timely Section 94 election. Respondent had made the required election which, under Section 94(e), included acceptance of the earlier terms letter. In a letter dated December 14, 1959 (App. 67), respondent stated that it "irrevocably elects to have Section 94 of the Technical Amendments Act of 1958, also known as the Retirement-Straight Line Adjustment Act of 1958, apply to the determination of its Federal tax liability for all applicable years." In effect, respondent "irrevocably" accepted the terms letter a second time, eleven years after the decision in *Brown Shoe*, and indicated by the omission of donated assets from its revised schedule of depreciable property its continuing understanding that those assets were not to be depreciated.

It is true, as the majority below suggested, that the exclusion of donated property from respondent's depreciable base reflected the Commissioner's "opinion" that these assets were not depreciable. Indeed, it is hardly likely that the terms letter would have contained conditions which the Service did not believe to be consistent with the tax laws. It is difficult to understand, however, on what basis the majority of

the Court of Claims could have concluded that these conditions, which respondent "irrevocably" accepted, were not intended to be binding. The majority's suggestion (Pet. 10a) that it is "reasonable to infer that plaintiff acquiesced in the condition, without agreeing with it, simply to avoid possible refusal of its requested change in accounting methods" is somewhat baffling. The fact is that respondent agreed, in return for authorization of its accounting changes, to abide by the conditions of the terms letter. We know of no principle of contract law which would allow respondent to avail itself of the Commissioner's authorization while avoiding the conditions for that authorization on the basis of an unstated mental reservation not to be bound by respondent's end of the agreement.

CONCLUSION

For the reasons stated, the judgment of the Court of Claims should be reversed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1939 (26 U.S.C. 1952 ed.):

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

*   *   *   *   *

(l) [as amended by Sec. 121(c), Revenue Act of 1942, c. 619, 56 Stat. 798] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

*   *   *   *   *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

*   *   *   *   *

(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

*   *   *   *   *

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor

upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

(b) [as amended by Sec. 1, Act of July 14, 1952, c. 741, 66 Stat. 629] *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(i) allowed as deductions in computing net income under this chapter or prior income tax laws, and

(ii) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this chapter (other than subchapter E), subchapter E of chapter 2, or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this chapter or prior income tax laws. * * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property.

*   *   *   *   *

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 167. DEPRECIATION.

(a) *General Rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

*   *   *   *   *

(f) *Basis for Depreciation.*—The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

*   *   *   *   *

SEC. 1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

SEC. 1012. BASIS OF PROPERTY—COST.

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P. relating to capital gains and losses). * * *

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